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IN THE

Supreme Court of the United States

OCTOBER TERM, 1942

No. 829

ESTATE OF ROBERT LYONS HAGUE, Deceased, City Bank Farmers Trust Company and Walter E. Godfrey, Executors,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

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Press of Fremont Payne, Inc.

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PETITION FOR WRIT OF CERTIORARI

TO THE HONORABLE, THE CHIEF JUSTICE AND THE ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

The petition of the Estate of Robert Lyons Hague, Deceased, City Bank Farmers Trust Company and Walter E. Godfrey, Executors, respectfully represents:

Summary Statement of Matter Involved

The petitioners are the executors of the estate of Robert Lyons Hague, deceased, duly appointed, qualified and acting as such pursuant to a decree of the Surrogate's Court of the County of New York, State of New York, dated March 29, 1939 (R. 78).

The controversy here involved relates to deficiencies in Federal income taxes of the decedent, Robert Lyons

Hague, in the following amounts: $154,872.93 for the calendar year 1936, $50,008.48 for the calendar year 1937, and $150,048.74 for the calendar year 1938 (R. 46, 61).

For the years in question the decedent reported as income and paid the proper tax on the following amounts: $45,454.56 for 1936, $50,004.04 for 1937, and $55,000.80 for 1938. These sums were received as salary from the decedent's employer, Standard Oil Company of New Jersey, by whom decedent was employed in an executive capacity as Manager of the Shipping Department (R. 79, 289).

More than a year after the decedent's death on March 8, 1939, the respondent determined additional taxes in the amounts of $208,104.25 for the year 1936, $50,008.48 for the year 1937, and $243,681.30 for the year 1938 (R. 13, 23, 32). These deficiencies were arrived at in the following manner:

During the years in question, the decedent maintained two personal bank accounts, the record of which show a continuous flow of funds through the accounts in the form of deposits and withdrawals, both in relatively small amounts but aggregating substantial sums when totalled for the particular year. A large majority of the deposits and withdrawals were cash transactions, and the decedent left no record of either the source or disposition of the funds. There was no accumulation of funds in the accounts (which were overdrawn nearly one-half the time and showed a combined average daily balance of less than $5,000 during the three years) or in any other ascertainable place or form, after diligent search by both the respondent and the decedent's executors (R. 89, *et seq.*).

The respondent determined additional income solely on the basis of the banking records, by totalling the deposits made in each year, subtracting therefrom amounts believed or determined to be other than income, and segregating the balance as "unidentified deposits". In this manner

about 50% of the total deposits over the three years were arbitrarily determined to be "income", or $346,154.87 for 1936, $94,456.10 for 1937, and $373,373.96 for 1938 (R. 80).

Before the Board of Tax Appeals (hereinafter referred to as the Tax Court) the petitioners, decedent's executors, sought to have the determination set aside first by showing on the facts that the determinations were at least substantially erroneous, and second by urging as a matter of law that no authority exists for determining income *by inference* from books of account with no supporting evidence to lend substance to such inference, and that where determinations are patently arbitrary and capricious, and shown to be substantially erroneous, no burden of proving the *full extent of the respondent's error* is imposed upon the taxpayer (R. 9, 20, 29).

The petitioners demonstrated before the Tax Court that substantial amounts of the "unidentified deposits" were in fact not income but were loans, proceeds of sale and other specific items (R. 89, *et seq.*). Effect was given quantitatively to this proof by the Tax Court, whose redeterminations of the tax (stated above as the amounts in issue) reduced the respondent's determinations by nearly $200,000 over the three years (R. 46, 61).

The petitioners' proof revealed, not only that certain specific deposits included by respondent were not income, which the Tax Court allowed in the substantial amounts already stated, but also revealed certain traits and habits of the decedent which if fully understood might well explain completely the non-income nature of the deposits in question. The full extent of decedent's many personal loan transactions in the years in question cannot be known, but the many debts owed by and owing to him at the time of his death shortly thereafter indicates that such loans accounted for many more of the unidentified deposits than those specifically described in the evidence. The same can

be said for his personal habits of withdrawing, carrying and redepositing large sums of money, and of "kiting" checks with his relatives and friends. There was evidence that a substantial though indeterminate portion of his disbursements were deductible business expenses.

By means of such proof, the petitioners showed first by specific facts that the respondent's determinations were substantially in error, and secondly that his error was actually much greater than could be shown by specific proof. If the respondent's determinations had been legally sufficient in the first place, or if he himself had been able at the hearing to offer proof of their legal sufficiency, the petitioners could not complain that the Tax Court gave no more effect to their proof than to reduce the respondent's determinations by the stated amounts.

But the evidence produced also proved the invalidity of respondent's *entire method of computation.* The petitioners did not claim to have proved by affirmative evidence that all the unidentified deposits were not income. It was their claim, however, that the respondent's determinations were arbitrary, capricious, unfounded upon any factual basis, and not entitled to any presumption of correctness, or in any event only a tenuous presumption fully overcome by the petitioner's proof. The determinations are so patently incorrect that the petitioners were not required, under recognized principles of law, to prove the full extent of the respondent's error.

As an indication of the unreasonableness of the determination, the deficiency notices upon which the Tax Court proceedings were based showed certain amounts of unidentified deposits as income (R. 13, 23, 32), while at the hearing the respondent found himself offering "proof" (consisting merely of Revenue Agents' computations based on the banking accounts) of substantially different amounts of income (R. 202, 267). One agent made the com-

putations for 1936 and 1937, while another agent, using a different method, made them for 1938. It is apparent, not only that the two agents would have reached radically different results in analyzing the deposits of any one year, but that no two persons engaged in the same task would be likely to agree either in theory or in result.

After the hearing before the Tax Court, the respondent, having discovered that the revenue agents' reports offered in evidence showed "unidentified deposits" substantially in excess of those shown in the 90-day letters, made motions to the Board for leave to amend his answers in order that the pleadings might conform to the proof. These motions were opposed by the petitioners, and prior to any determination thereof by the Tax Court the respondent withdrew the motions.

In his application to withdraw said motions, the respondent significantly admitted that he had failed to prove that the additional amounts of deposits were income, principally for the reason that the record fails to show the *source* of *any* of the unidentified deposits (R. 284, 286). The same reasoning applies not only to such additional amounts, but to all deposits included in income, and respondent's statement is an admission of failure to make a valid determination of taxable income.

The Tax Court, nevertheless, placed the entire burden of proving that the arbitrarily segregated "unidentified deposits" were not income upon the petitioners (R. 54, 71). This the law does not require where the respondent has failed to show any rational basis for his determinations. The respondent offered not the slightest proof that the unidentified deposits were income. In fact, he candidly admitted there is no proof that they were income. He stood solely on the bare fact that the deposits were made, and upon the presumption of correctness attached to his determinations.

On September 12, 1941 the Tax Court rendered its findings of fact and opinions sustaining the determinations of the respondent, as reduced by the specific amounts shown by the petitioners to be other than income (R. 46, 61). The Tax Court recognized that possession of unidentified sums of money does not affirmatively establish that those sums of money are income, but concluded that the respondent had made reasonable efforts to verify his conclusions from outside sources, and had thereby fulfilled his duty to make a valid and lawful determination (R. 57).

The Tax Court's decision was affirmed by the Circuit Court of Appeals for the Second Circuit on January 19, 1943. The Circuit Court reasoned that the respondent's determinations were "based on inferences properly drawn from the facts proved by the evidence, and were therefore entitled to be accepted as *prima facie* correct in the proceedings in the Tax Court" (R. 291).

The issue thus presented to this Court is whether a determination of taxable income can validly be made based solely upon records of bank deposits without any supporting evidence of source, accumulation or other circumstances sufficient to support a reasonable inference that the deposits were income, and whether such a determination places a burden of proof upon the taxpayer which is not fully satisfied by proof that the respondent erred substantially both in result and in method of computation.

Jurisdiction

1. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925, Chap. 229, Stat. 938, 28 U. S. C. A. Section 347 (a); Rev. Stat. Section 1008 as amended (28 U. S. C. A. Section 350).

2. The date of the entry of the judgment of the Circuit Court of Appeals for the Second Circuit herein sought to be reviewed is February 4, 1943 (R. 292).

Questions Presented

1. Did not the Circuit Court of Appeals for the Second Circuit err in holding that the respondent's determinations were not arbitrary and capricious, and were therefore *prima facie* correct?

2. Did not the Circuit Court of Appeals for the Second Circuit err in holding that the circumstances surrounding the deposit and withdrawal of money in and from the decedent's bank accounts gave such character to the transactions as to justify the respondent in determining that some or all of the deposits were income?

3. Did not the Circuit Court of Appeals for the Second Circuit err in holding that the respondent's determinations were based on inferences properly drawn from the facts proved by the evidence?

4. Did not the Circuit Court of Appeals for the Second Circuit err in holding that the respondent's determinations were sufficiently valid to place upon the petitioners the burden of proving them to be wrong?

5. Did not the Circuit Court of Appeals for the Second Circuit err in holding that the petitioners failed to prove the respondent's determinations and computations to be wrong, and failed to show that the tax imposed is erroneous?

6. Did not the Circuit Court of Appeals for the Second Circuit err in failing to hold that the respondent's determinations were made without statutory authority and in violation of constitutional rights and limitations?

7. Did not the Circuit Court of Appeals for the Second Circuit err in failing to hold that the respondent's determinations were so arbitrary and capricious as to violate due process and to represent not the exercise of the power

of taxation but a confiscation of property within the meaning of *Heiner* v. *Donnan*, 285 U. S. 312, and other decisions of this Court?

8. Did not the Circuit Court of Appeals for the Second Circuit err in failing to hold that the respondent's determinations were shown to be without rational foundation, arbitrary, and excessive, and were therefore invalid within the meaning of *Helvering* v. *Taylor*, 293 U. S. 507, and entitled to no presumption of correctness?

9. Did not the Circuit Court of Appeals for the Second Circuit err in failing to hold that by proving the respondent's determinations and the method of their computation to be substantially erroneous, the petitioner—not being required to prove the full extent of the respondent's error—had fully sustained their burden of proof and were entitled, not merely to reduction of the amounts of tax, but to reversal of the determinations in their entirety?

10. Did not the Circuit Court of Appeals for the Second Circuit err in failing to hold that the respondent's formal admission before the Tax Court that the deposits had not been proven to be income relieved the petitioners of any affirmative burden of *proving* that the deposits were not income, and entitled the petitioners to a decision in their favor?

Reasons Relied on for the Allowance of the Writ

The decision of the Circuit Court of Appeals for the Second Circuit involves a question of far-reaching importance which has never before been presented to this Court. No direct authority in statute or even regulation exists to justify the respondent's method of determining taxable income in this case.

The method adopted by the respondent, of arbitrarily segregating certain items whose substantive existence is

evidenced only by banking records, and whose status as income the respondent admittedly cannot prove, then placing the burden on the taxpayer of proving that these items are not income, represents an example of abuse of power, administrative oppression, and veritable confiscation of property which violates the Constitution. The existence of the power to tax in this manner is here most earnestly questioned; the power of Congress to tax income is limited by the Sixteenth Amendment, a limitation which prevents and prohibits the taxation as income of that which is not in fact income. That limitation is equally binding upon the Commissioner in the determination of taxable income.

Heiner v. *Donnan,* 285 U. S. 312;
Eisner v. *Macomber,* 252 U. S. 189;
Burnet v. *Sanford & Brooks Co.,* 282 U. S. 359;
Nichols v. *Coolidge,* 274 U. S. 531;
Helvering v. *City Bank Farmers Trust Company, Trustee,* 296 U. S. 85.

Assuming that the power to determine taxable income in this manner exists, it presents peculiar and grave dangers of abuse and oppression which should be carefully circumscribed with the appropriate constitutional limitations. It is assumed that the Commissioner cannot point to certain property and say to the taxpayer, "While I have no reason to believe that this property represents income to you in this year or any other year, you must either prove that it is not income or pay a tax as if it were income." How much less should he be able to do this when there is only secondary or circumstantial evidence of the real existence of the property?

While the banking records are evidence that each deposit was in fact made in the form of substantive property, they are no evidence that each deposit represented separate or additional funds, having a cumulative or aggregate existence, and certainly no evidence that *any* of the deposits was *income,* either in the current year or any other time.

The lawful scope or sphere within which a dangerous power may be exercised must be clearly defined. The constitutional limitations within which the power of taxation may be exercised have a real existence at all times, but until application to a specific practice, relationship, or set of facts their effective existence is only potential. Specific bounds have been defined by the Supreme Court in many instances, but not with respect to the use of the records of bank deposits in determining income.

If this power exists, it is of very great importance to taxpayers generally that the constitutional limitations should be prescribed. The respondent has gone further in this instance than ever before in using bank records as the sole basis for determining income, and it is therefore timely and appropriate that the definitions should be drawn at this time.

It appears to be well established and accepted by both the lower courts that a valid determination of taxable income cannot be made from banking records alone, unsubstantiated by other evidentiary facts. Yet the only supporting facts presented by the respondent were inferences drawn from those records. How then can it be said that the respondent has fulfilled his duty to make a valid determination?

There is admittedly no evidence that the unidentified deposits were income. Yet the lower courts both held that the respondent has the power to make a statutory determination of income based solely on records of those deposits, which by some mystical process places the admittedly impossible burden on the petitioners of proving that the deposits were not income. *Can a determination of the respondent be of any greater efficacy or potency than the evidence upon which it is based?* Under these circumstances the presumption of correctness becomes pure fiction, and the taxpayer's burden of proof a travesty upon justice.

To meet such situations, an equitable doctrine has been evolved to the effect that imposition of the burden of proof

upon the taxpayer should not be allowed to countenance an obvious injustice, such as permitting the Commissioner to escape his statutory duty of determining a valid tax.

Manchester Board & Paper Co. v. *Commissioner,* 74 F. (2) 838;
Underwood v. *Commissioner,* 56 F. (2) 67;
Radin v. *Commissioner,* 33 F. (2d) 39.

That principle was approved and adopted by this Court in *Helvering* v. *Taylor,* 293 U. S. 507, in which it was held that a determination of the Commissioner shown to be without rational foundation is entitled to no presumption of correctness; where the taxpayer's evidence shows the determination to be arbitrary and excessive, even though he fails to sustain his burden of proving the full extent of the Commissioner's error, the taxpayer is not required to establish the correct amount of the tax.

In numerous lower court cases, records of bank deposits have been used as the *starting point* in the determination of taxable income, but use of such evidence has never been approved unless corroborated by direct proof of such facts as the source of the funds, their accumulation in the bank account or elsewhere, or some circumstance such as fraudulent or illegal conduct on the part of the taxpayer sufficient to give rise to a presumption that the deposits represented income.

Holmstrom v. *Commissioner,* 84 F. (2) 743 aff'g 35 B. T. A. 1092 (bank records used only to corroborate evidence otherwise obtained);
Mauch v. *Commissioner,* 113 F. (2) 555 (deposits traced to professional sources; fraud and concealment proved);
Calafato v. *Commissioner,* 124 F. (2) 187 (evidence of illegal sources; deposits used only as evidence of fraud);
Hoefle v. *Commissioner,* 114 F. (2) 713 (evidence of source, accumulation, and intent to defraud);

Leonard B. Willits, 36 B. T. A. 294 (identification of source, evidence of accumulation and fraud);
James L. Robertson, 20 B. T. A. 112 (use of deposits as evidence disapproved; taxpayer identified some of the deposits);
James Pantazas, 5 B. T. A. 974 (source of deposit income proved);
Edward P. Haney, 5 B. T. A. 1039 (deposits as income corroborated by proof of source);
Homer P. Morris, 9 B. T. A. 1273 (source proven-share-cropper tenants, farm store, cotton gin);
Katharine Wilkinson Barnette, 16 B. T. A. 1390 (source proven—identified oil royalty transactions);
E. M. Green, 11 B. T. A. 185 (proven source—illicit sales of whiskey);
I. Goldman, 12 B. T. A. 875 (proof of source and accumulation);
Robert Burd, 19 B. T. A. 734 (evidence of accumulation and fraudulent concealment);
Mary B. Tolson Becker, B. T. A. memo, Docket No. 88443, June 5, 1940 (use of deposits in determining decedent's income disapproved on *Helvering* v. *Taylor,* 293 U. S. 507—determinations shown to be substantially erroneous and held to be invalid).

An *inference* as to the existence of income must, by all the principles of justice as well as by all the decided cases, be supported by evidentiary facts before it attains the dignity and legal significance of a *presumption.* The record discloses no evidence tending to establish that the deposits were income other than the reports, analyses and schedules compiled by revenue agents solely from the banking records themselves.

It is well settled that reports of revenue agents are not evidence, and that a deficiency based on a revenue agent's report which is erroneous on its face must be disallowed.

Garnet I. McMahon, Inc. v. *U. S.*, 61 Ct. Cl. 559;
John M. Parker Co. v. *Commissioner*, 11 B. T. A. 1236, 49 F. (2) 254;
Schlemmer & Graber Co., 2 B. T. A. 823;
Bruce & Human Drug Co., 1 B. T. A. 342;
The Acorn Refining Co., 2 B. T. A. 253;
G. A. Miller, 6 B. T. A. 401;
Index Notion Co., 3 B. T. A. 90.

By what strange process, then, has a set of facts having practically no probative weight, or at best only sufficient to support an "inference," acquired such significance and self-sufficiency as to amount to a "presumption" merely by virtue of being set forth in a statutory deficiency letter?

Both lower courts recognized the principle that something must be added to the banking records themselves to support a valid determination. What were those all-important additional facts that were supposedly supplied in this instance? The Tax Court declared that the respondent made "reasonable efforts" to verify his conclusions from outside sources, and thereby fulfilled his duty to make a valid and lawful determination (R. 55).

The Circuit Court observed that the circumstances surrounding the deposit and withdrawal of money in and from bank accounts may justify a determination of income, and, after reviewing certain of the supposed facts of the case, held that the determinations were based on inferences properly drawn from the proven facts and were entitled to be accepted as *prima facie* correct.

But the facts reviewed by the Court and regarded as sufficient evidence to support the determinations were nothing more than analyses of the banking records made by respondent's agents. The banking records still remain the sole and uncorroborated basis for the determinations; nothing was presented in the nature of evidence which could properly transmute a mere inference into a presumption.

It is believed that the issues so raised are fundamental: can a valid determination of taxable income be made based solely upon secondary or circumstantial evidence which is admittedly of no weight and incompetent to make out a *prima facie* case by the established rules of evidence; is such a determination presumptively correct to such an extent that the taxpayer is under the burden of proving it to be incorrect, where there is no material evidence that it is correct; and to overcome any presumption of correctness attaching to the determination is the taxpayer bound to prove not only that the determination was substantially erroneous but also the full extent of the respondent's error.

Wherefore, your petitioners respectfully pray that a writ of certiorari be issued out of and under the seal of your Honorable Court directed to the United States Circuit Court of Appeals for the Second Circuit, commanding that Court to certify and send to your Honorable Court, on a day certain to be therein named, a full and complete transcript of the record of all proceedings in the case of *Estate of Robert Lyons Hague, Deceased, City Bank Farmers Trust Company and Walter E. Godfrey, Executors,* Petitioners, v. *Commissioner of Internal Revenue,* Respondent, bearing docket No. 283, to the end that the judgment of the United States Circuit Court of Appeals for the Second Circuit may be reviewed and reversed by your Honorable Court, and for such other and further relief as may seem meet and proper.

And your petitioner will ever pray, etc.

CITY BANK FARMERS TRUST COMPANY,
and WALTER E. GODFREY, EXECUTORS,
Petitioners,
By FRED R. ANGEVINE,
Attorney for Petitioners.

AARON H. MARX,
RICHARD O. MERRICK,
of Counsel.

The undersigned counsel of record hereby certifies that the foregoing petition is well founded and is not interposed for the purpose of delay.

FRED R. ANGEVINE,
Attorney for Petitioners.